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## BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL  
Chairman  
JIM IRVIN  
Commissioner  
MARC SPITZER  
Commissioner

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IN THE MATTER OF THE APPLICATION OF  
ARIZONA-AMERICAN WATER COMPANY,  
INC. FOR A LIMITED WAIVER OF THE  
REQUIREMENTS OF A.A.C. R14-2-801, ET SEQ.,  
AND CERTAIN RELATED RELIEF.

Docket No. W-01303A-01-0983

STAFF'S CLOSING BRIEF

The Arizona Corporation Commission Staff ("Staff") hereby provides its closing brief in this matter in accordance with the Administrative Law Judge's procedural order.

**BACKGROUND****I. The Application.**

On December 17, 2001, Arizona-American Water Company ("Arizona-American") filed an application with the Arizona Corporation Commission ("Commission") requesting that the Commission waive the requirements of Arizona Administrative Code ("A.A.C.") R14-2-801 through -806<sup>1</sup> with respect to a pending transaction involving Arizona-American's parent corporation, American Water Works Company, Inc. ("American Water Works"). On September 16, 2001, American Water Works entered an agreement with RWE AG ("RWE"), a company organized under the laws of the Federal Republic of Germany, to merge with one of RWE's subsidiaries. In its application, Arizona-American asked the Commission to waive the requirements of A.A.C. R14-2-801 through -806 or, in the alternative, to conclude that the Commission lacks jurisdiction over the transaction.

<sup>1</sup> These A.A.C. rules under Article 8 are titled "Public Utility Holding Companies and Affiliated Interests" ("affiliated interest rules" or "rules").

1 On April 22, 2002, at the suggestion of Staff, Arizona-American filed an amendment to its  
2 original application. The amendment contained the information required for a notice of intent to  
3 reorganize pursuant to A.A.C. R14-2-803(A). Despite this subsequent filing, Arizona-American  
4 continues to urge the Commission to waive the application of the rules to this transaction or to  
5 conclude that it lacks jurisdiction over this transaction. In the alternative, Arizona-American requests  
6 that the Commission approve the transaction.

7 **II. The Transaction.**

8 American Water Works, Inc., the current parent company of Arizona-American Water  
9 Company, will merge with Apollo Acquisition Company, which is a wholly owned subsidiary of  
10 Thames Water Aqua U. S. Holdings, a Delaware corporation. (Tr. at 74, 77-78). After the merger,  
11 American Water Works, Inc. will be the surviving entity, and it will then be a wholly owned  
12 subsidiary of Thames Water Aqua U. S. Holdings.<sup>2</sup>

13 Thames Water Aqua U. S. Holdings will be a direct subsidiary of Thames Water Aqua  
14 Holdings GmbH, a German holding company, which in turn is a direct subsidiary of RWE. (Tr. at  
15 75). Thames Water Aqua U. S. Holdings will be an American holding company, serving as a single  
16 "umbrella" company under which RWE plans to place all of its American water assets. Id.

17 The following list provides a summary of the holding company structure post merger:

- 18 A. RWE AG, a company organized under the laws of the Federal Republic of Germany,  
19 (tr. at 75);
- 20 B. Thames Water Aqua Holdings GmbH, a German holding company, (tr. at 76);
- 21 C. Thames Water Aqua U. S. Holdings, a Delaware Corporation, id.;
- 22 D. American Water Works Company, Inc., id.; and
- 23 E. Arizona-American Water Company, (tr. at 79).

24  
25  
26  
27 <sup>2</sup> This is somewhat different from the information filed in the original application. At that time, it was anticipated that  
28 Apollo Acquisition Company would be a wholly owned subsidiary of Thames Water Aqua Holdings, the German holding  
company. As a result of the merger, American Water Works Company, Inc. would have been a wholly owned subsidiary  
of Thames Water Aqua Holdings. (Tr. at 74).

1 RWE has delegated the management of its various water operations worldwide to Thames Water Plc,  
2 a corporation organized under the laws of England and Wales, which will be a sister affiliate of  
3 Thames Water Aqua U. S. Holdings. (Tr. at 76, 77, 78).

#### 4 ARGUMENT

##### 5 **I. The Commission has jurisdiction over this transaction pursuant to its affiliated interest** 6 **rules, A.A.C. R14-2-801 through -806.**

7 Arizona-American has argued that the Commission lacks jurisdiction over this transaction.  
8 (Turner Rebuttal at 8-9). In support of this statement, the Company argues that none of the parties to  
9 the agreement, i.e., American Water Works, Thames Holdings, or RWE, are Arizona corporations,  
10 are doing business in Arizona, or are providing utility service in Arizona. (Turner Rebuttal at 9).  
11 This argument fails to focus on the effects of the transaction upon Arizona-American, the Arizona  
12 utility.

13 The affiliated interest rules were designed to prevent utility ratepayers from having to bear the  
14 burden of financial risk resulting from holding company diversification. See Arizona Corp. Comm'n  
15 v. State ex rel. Woods, 171 Ariz. 286, 295-96, 830 P.2d 807, 816-17 (1992). In drawing this  
16 conclusion, the Arizona Supreme Court concluded that "[t]he utility enterprise must be viewed as a  
17 whole without regard to the separate corporate entities . . . ." Id. at 296, 830 P.2d at 817 (quoting  
18 General Tel. Co. v. Public Utilities Comm'n, 34 Cal. 3d 817, 670 P.2d 349, 355, 195 Cal. Rptr. 695,  
19 701 (1983)). The Court recognized that intercorporate dealings and reorganizations can place the  
20 public utility at risk. Woods, 171 Ariz. at 196, 830 P.2d at 817.

21 In this case, no one disputes that the reorganization may have an effect upon the Arizona  
22 utility's cost of capital. (Tr. at 40). In fact, Arizona-American cites these potential effects as  
23 benefits. (Turner Rebuttal at 10-11). Arizona-American's witnesses contend--and Staff does not  
24 disagree with them--that Arizona-American may benefit from RWE's credit ratings, which are higher  
25 than American Water Works' current credit ratings. (McGivern Rebuttal at 6; Reiker Direct at 2-4).  
26 According to Mr. McGivern, "[t]he higher credit ratings for RWE as compared to those of AWCC  
27  
28

1 [American Water Works] offer a rate differential that will impact positively the cost of capital in the  
2 future.” (McGivern Rebuttal at 6).

3 If the credit rating of a parent company can positively impact the cost of capital of a utility  
4 affiliate, it can also negatively impact it. (Tr. at 58). If RWE’s credit ratings were to fall in the  
5 future, the positive benefits that Arizona-American anticipates would fail to materialize and would in  
6 all likelihood be replaced by negative ones. This illustrates that utility rates can be impacted by the  
7 holding company structure, and it is exactly those impacts that the affiliated interest rules were  
8 intended to evaluate and address.

9 In the Woods case, the opponents of the affiliated interest rules raised arguments similar to  
10 those raised by Arizona-American. Specifically, they contended that the Commission could not  
11 impose any requirements upon a public service corporation’s affiliates, because the Commission’s  
12 constitutional authority does not extend to those entities. Woods, 171 Ariz. at 290, 830 P.2d at 811.  
13 The Court rejected those arguments, concluding that “the Commission must have the power to obtain  
14 information about, and take action to prevent, unwise management or even mismanagement and to  
15 forestall its consequences in intercompany transactions significantly affecting a public service  
16 corporation’s structure or capitalization.” Id. at 296, 830 P.2d at 817. No one disputes that this  
17 transaction will affect not only the overall holding company structure but also Arizona-American’s  
18 capitalization. (Tr. at 83-84). This transaction clearly falls within the ambit of the affiliated interest  
19 rules.

20  
21 **II. The Commission should not waive the requirement to review and approve this transaction.**

22 Arizona-American argues that, even if the Commission has jurisdiction over this transaction,  
23 it should waive the requirement to review it, because the transaction will not have any impact upon  
24 the capital structure of Arizona-American or its cost of providing utility service. (Application for  
25 Waiver at 5). This statement, however, appears to contradict the Company’s claims that affiliation  
26 with RWE will result in lower costs of capital--and consequently a lower cost of providing utility  
27 service--to Arizona-American. (Tr. at 39-41). To explain this apparent contradiction, Witness  
28 Turner adopted a distinction that appears to split hairs:

1 [t]he transaction itself causes no change to the operations of Arizona-American. The  
2 results following the transaction because of the financial strength could in fact give,  
3 inure benefits to Arizona-American theoretically.

4 (Tr. at 41 (emphasis added)). This statement views the transaction too narrowly and is nothing but a  
5 rationalization by which the Company seeks to avoid review. It is the possible results of these kinds  
6 of transactions that concerned the court in Woods: “many critics ‘fear that financial improvement  
7 through unregulated diversification will come at the expense of utility ratepayers.’” 171 Ariz. at 296,  
8 830 P.2d at 817 (quoting Joan G. Fickinger, Comment, Jurisdiction of State Regulatory Commissions  
9 over Public Utility Holding Company Diversification, 15 Loy.U.Chi.L.J. 87, 95 (1983) (emphasis in  
10 original)). Some of the possible threats to ratepayers recognized by the Woods court include  
11 charging excessive fees to the public utility, utilizing fraudulent accounting practices, siphoning  
12 public utility revenue, and creating fragile corporate structures by risky management practices.  
13 Woods, 171 Ariz. at 296, 830 P.2d at 817. Most, if not all, of these dangers would occur after the  
14 transaction rather than in the transaction itself. Accordingly, the distinction that the Company draws  
15 is too fine and would not allow the Commission to apply the affiliated interest rules in a way that will  
16 maximize protections to ratepayers.

17 In addition, if the Commission waives review of this transaction, then it will forego the  
18 opportunity to impose conditions upon it. Although Staff witness Carlson has recommended  
19 approval of the transaction, he believes that approval is appropriate only if the Commission imposes  
20 conditions to protect ratepayers from the most likely potential dangers. (Tr. at 125-26). The  
21 Commission should deny the Company’s request for a waiver from Commission review of this  
22 transaction.

23  
24 **III. The Commission should condition the approval of this transaction upon the fifteen  
conditions set forth in Exhibit S-1.**

25 Before the hearing in this matter, Staff and the Company had the opportunity to meet to  
26 discuss Staff’s proposed conditions. Through these discussions, the parties were able to substantially  
27 narrow the disputes related to the conditions. As a result of these discussions, Staff proposed a new  
28 set of conditions, which are set forth in S-1, to substitute for the original conditions, which are

1 contained in Staff's prefiled testimony. (Tr. at 114). The Company accepts the conditions as set  
2 forth in S-1, except in three instances: conditions 3, 5, and 13. (Tr. at 33).

3 Condition No. 3 provides that

4 Arizona-American and its affiliates shall provide their books and records, upon  
5 request, in the Phoenix metropolitan area. Arizona-American and its affiliates shall  
also provide access to their books and records where such documents are maintained.

6 The Company opposes the imposition of Condition No. 3. The Company offers instead to comply  
7 with the affiliated interest rules or to seek waivers thereof. (Turner Rebuttal at 17). Staff believes  
8 that this proposal is not sufficient. It does not cover the other possible situations in which Staff may  
9 need access to the books and records of one of the Company's affiliates. (Tr. at 142-43). As Staff  
10 witness Carlson testified, there might be a need to look at the books and of an affiliate that doesn't do  
11 business directly with Arizona-American, because Staff might perceive that the affiliate is causing  
12 costs to fall unfairly on Arizona-American's ratepayers. (Tr. at 143).

13 Condition No. 3 is supported by Arizona law. The Commission has the authority to undertake  
14 any "necessary step" to ensure that a company's rates are just and reasonable. See Woods, 171 Ariz.  
15 at 295, 830 P.2d at 815; Ethington v. Wright, 66 Ariz. 382, 392, 189 P.2d 209, 216 (1948). The  
16 Commission has the authority to require access to a utility affiliate's books and records when such  
17 access is necessary for effective ratemaking, see Woods, 171 Ariz. at 289, 830 P.2d at 810, and the  
18 Company's new parent will not be getting off to a good start in Arizona by denying this basic  
19 authority. The affiliated interest rules are an example of the Commission's exercise of its authority  
20 over affiliates when necessary for effective ratemaking; it is not the outermost limit of that authority.  
21 The Commission should reject the Company's efforts to limit Condition No. 3 to the confines of the  
22 affiliated interest rules. Arizona law supports broader access to affiliate books and records, and the  
23 Commission should adopt Condition 3 as proposed in Staff Exhibit S-1.

24 Condition No. 5 provides that

25 [i]n future rate proceedings filed after the effective date of the reorganization,  
26 Arizona-American shall have the burden of demonstrating that any cost overhead  
27 allocations and direct charges resulting from the reorganization including, but not  
28 limited to, the addition of layers of management, are reasonable and provide a net  
benefit to Arizona-American and/or its customers.

1 The Company, while not disagreeing completely with Condition No. 5, opposes the use of the word  
2 "net." (Tr. at 18). Company witness Turner testified that, in his experience, the word "net" implies a  
3 comparison between two items with a resulting numerical value, either plus or minus, in the end. (Tr.  
4 at 19). Mr. Turner believes that there may be situations in which Arizona-American may experience  
5 a "net benefit" from a transaction with an affiliate, but that benefit may not necessarily be a rate  
6 decrease. (Tr. at 19-20). The Company suggests substituting the term "tangible real" in place of the  
7 word "net." (Tr. at 20).

8 From Staff's perspective, the problem with the phrase "tangible real benefit" is that it appears  
9 to omit any comparison of the cost of the transaction with its benefits. Most transactions will have  
10 some "tangible real benefit"; the more crucial question is whether the cost of the transaction is  
11 reasonable in relation to the benefit. This is the concept that Staff is trying to capture when it talks  
12 about "net benefits." The word "net" implies a comparison, though not necessarily a numerical one.  
13 (Tr. at 120-21). In Staff's opinion, the term "tangible real benefit" omits this element of comparison,  
14 focusing on the nature of the benefit only while failing to evaluate the cost. (Tr. at 36). Staff  
15 recommends that the Commission retain the term "net benefit" as it currently appears in Exhibit S-1.  
16 If, however, the Commission would like to amend Condition No. 5, Staff suggests that the  
17 Commission use language that will embody the notion of comparison, i.e., that the cost involved  
18 should be reasonable in relation to the benefit. (Tr. at 35-36).

19 Condition No. 13 provides that

20 [t]he cost of debt issued after the closing date of the reorganization, for purposes of  
21 setting rates in Arizona-American's rate proceedings, filed within ten years from the  
22 effective date of the reorganization, shall reflect a rating of A- (S&P) / Baa1  
(Moody's) or higher.

23 The Company has asked for a three-year minimum bond rating protection period, instead of a ten-  
24 year protection period. (Tr. at 27). The Company contends that to, in effect, "freeze" its bond rating  
25 for more than three years will increase the Company's risk. (Tr. at 29-30).

26 Staff believes that the longer ten-year protection period that it has proposed is better than the  
27 Company's proposal and provides better protection to Arizona ratepayers. While a longer protection  
28 period would provide even greater protection, Staff is cognizant and sensitive to bond rating changes

1 in the indefinite future and finds it reasonable to limit the protection period to a relevant time frame.  
2 The three-year proposal would be irrelevant if the Company never issued debt within three years and  
3 would serve no protection beyond three years.

4 Although the Company suggests that the transaction may benefit Arizona-American by  
5 lowering its cost of capital, this benefit cannot be quantified and it may not materialize. (Reiker  
6 Direct at 6). For this reason, Staff believes that it is necessary to protect ratepayers from the potential  
7 of increased rates due to any possible downgrading in the Company's or its affiliates' bond ratings.  
8 Condition No. 13 is intended to address this issue, and Staff recommends that the Commission  
9 approve the phrasing as proposed by Staff in Exhibit S-1.

10 **IV. Conclusion.**

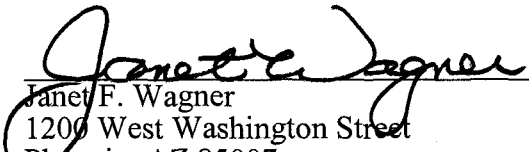
11 Staff recommends the following:

- 12 A. The Commission should determine that it has jurisdiction to review this transaction  
13 pursuant to Article XV, Section 3 of the Arizona Constitution and A.A.C. R14-2-803.  
14 B. The Commission should conclude that a waiver for review of this transaction is not  
15 appropriate.  
16 C. The Commission should approve the transaction subject to the fifteen conditions set  
17 forth in Exhibit S-1.  
18 D. Finally, the Commission should adopt Staff's version of Conditions 3, 5, and 13.

19 For the reasons set forth in this brief, Staff requests that the Commission enter an order  
20 incorporating the four recommendations set forth in the previous paragraph.

21 Respectfully submitted this 6<sup>th</sup> day of September, 2002.

22 ARIZONA CORPORATION COMMISSION

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1 Original and ten copies of the foregoing  
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